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IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

20TH CENTURY INSURANCE CO., *et al.*,
Petitioners,

v.

JOHN GARAMENDI, INSURANCE COMMISSIONER, *et al.*,
Respondents.

Petition for a Writ of Certiorari to the Supreme Court of California

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Did the California Supreme Court err in concluding that a regulated entity is not entitled under the Fifth and Fourteenth Amendments to an opportunity to recover its cost of capital in the rates it is permitted to charge?

PARTIES TO THE PROCEEDING AND RULE 29.1 STATEMENT

Petitioners 20th Century Insurance Company and 21st Century Casualty Company were respondents before the California Supreme Court and plaintiffs before the Superior Court for the County of Los Angeles in cases No. SFSC 938470 and No. BS 016789, which were consolidated. Petitioners State Farm Mutual Automobile Insurance Company, State Farm Fire and Casualty Company, and State Farm General Insurance Company were respondents before the California Supreme Court and plaintiffs before the Superior Court for the County of Los Angeles in *Hartford Steam Boiler Inspection and Ins. Co.* v. *Garamendi*, No. BC 023983, which was consolidated in part with the actions brought by 20th Century Insurance Company and 21st Century Casualty Company. Pursuant to S. Ct. Rule 29.1, petitioners note that 20th Century Insurance Company and 21st Century Casualty Company are wholly-owned subsidiaries of 20th Century Industries. State Farm Mutual Automobile Insurance Company is a mutual insurer owned by its policyholders, and State Farm Fire and Casualty Company and State Farm General Insurance Company are wholly-owned subsidiaries of State Farm Mutual Automobile Insurance Company. State Farm Mutual Automobile Insurance Company, State Farm Fire and Casualty Company, and State Farm General Insurance Company have no non-wholly owned subsidiaries.

Respondent John Garamendi, appellant before the California Supreme Court and defendant before the Superior Court, is the California Insurance Commissioner. Respondent Voter Revolt intervened in the Superior Court and was an appellant before the California Supreme Court.

The following entities were also respondents before the California Supreme Court and plaintiffs before the Superior Court in *Hartford Steam Boiler Inspection and Ins.*

Co. v. *Garamendi*, No. BC 023983: Hartford Steam Boiler Inspection & Insurance Company, Federal Insurance Company, Vigilant Insurance Company, Sea Insurance Company, Northwestern Pacific Indemnity Company, Sun Insurance Office, Limited, Alliance Assurance Company, Limited, Pacific Indemnity Company, Houston General Insurance Company, Avemco Insurance Company, Eastern Aviation and Marine Insurance Company, National Insurance Underwriters, Charter Oak Fire Insurance Company, Travelers Indemnity Company, Travelers Indemnity Company of Rhode Island, Travelers Indemnity Company of America, Phoenix Insurance Company, Travelers Indemnity Company of Illinois, Bankers & Shippers Insurance Company of New York, Century National Insurance Company, Great American Insurance Company, Stonewall Insurance Company, Transport Insurance Company, General Accident Insurance Company, Pennsylvania General Insurance Company, Camden Fire Insurance Company, Coast National Insurance Company, Home Insurance Company, Home Indemnity Company, Home Insurance Company of Indiana, City Insurance Company, Balboa Insurance Company, Meritplan Insurance Company, Newport Insurance Company, Farmers Home Mutual Insurance Company, Western Home Insurance Company, American Continental Insurance Company, Sterling Casualty Insurance Company, Topa Insurance Company, Highlands Insurance Company, Highlands Underwriters Insurance Company, American Bonding Company, Continental Insurance Company, Boston Old Colony Insurance Company, Fidelity & Casualty Company of Newark, New Jersey, Fidelity & Casualty Company of New York, Fireman's Insurance Co. of Newark, New Jersey, Glens Falls Insurance Company, Kansas City Fire & Marine Insurance Company, Mayflower Insurance Company, Ltd., Niagara Fire Insurance Company, Pacific Insurance Company, Farmers Insurance Exchange, Fire Insurance Exchange, Mid-Century Insurance Company, Truck Insurance Exchange, Allstate Insurance Company, Allstate Indemnity Company, Northbrook Property and

Casualty Insurance Company, Northbrook Indemnity Company, Northbrook National Insurance Company, USAA Casualty Insurance Company, USAA General Indemnity Company, United Services Automobile Association, American Bankers Insurance Company of Florida, Sequola Insurance Company, National Chiropractic Mutual Insurance Company, Republic Mortgage Insurance Company, Old Republic Insurance Company, Zurich Insurance Company, American Zurich Insurance Company of Illinois, American Zurich Insurance Company, American Guarantee & Liability Insurance Company, Empire Fire & Marine Insurance Company, Universal Underwriters Insurance Company, Heritage Indemnity Company, Montgomery Ward Insurance Company, Forum Insurance Company, Motors Insurance Corporation, MIC General Insurance Corporation, MIC Property & Casualty Insurance Corporation, CIM Insurance Corporation, National General Insurance Company, Preferred Risk Mutual Insurance Company, Mid-West Mutual Insurance Company, Government Employees Insurance Company, GEICO General Insurance Company, GEICO Indemnity Company, and Criterion Casualty Company. Certain of these *Hartford Steam Boiler* parties are filing a separate petition for certiorari seeking review of the judgment below.

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PETITION FOR A WRIT OF CERTIORARI

Petitioners 20th Century Insurance Company and 21st Century Casualty Company ("20th Century") and State Farm Mutual Automobile Insurance Company, State Farm Fire and Casualty Company, and State Farm General Insurance Company ("State Farm"), respectfully pray that a writ of certiorari issue to review the judgment and opinion of the Supreme Court of California entered in the above captioned case on August 18, 1994.

OPINIONS BELOW

The opinion of the California Supreme Court is reported at 8 Cal. 4th 216, 878 P.2d 566, 32 Cal. Rptr. 2d 807, and is reprinted in the appendix hereto ("App.") at 1a. The decision of the Los Angeles Superior Court is not reported and is reprinted at App. 136a. The decision of the Administrative Law Judge, which was adopted by the California State Insurance Commissioner, is not reported and is reprinted at App. 215a.

JURISDICTION

The California Supreme Court issued its opinion on August 18, 1994. App. 1a. That court modified its opinion and denied a timely petition for rehearing on September 29, 1994. *Id.* at 134a, 214a. The jurisdiction of this Court rests on 28 U.S.C. § 1257(a).

PERTINENT CONSTITUTIONAL, STATUTORY, AND REGULATORY PROVISIONS

Pertinent provisions of the Fifth and Fourteenth Amendments to the United States Constitution, Section 1861 of the California Insurance Code, and Title 10, sections 2643-45 of the California Code of Regulations, are set forth at App. 375a-399a.

INTRODUCTION

As a result of his implementation of California Proposition 103, the California Insurance Commissioner ordered petitioner 20th Century to pay back 78 million dollars in insurance premiums it had charged its insureds from November 1988 to November 1989. 20th Century challenged the order as confiscatory, in violation of the Takings and Due Process Clauses of the United States Constitution. The courts below articulated and applied two very different standards in assessing this constitutional claim, based on two very different readings of this Court's precedents, and arrived at two different conclusions.

The Superior Court looked to the standard set forth in *Federal Power Comm'n* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), and concluded that the rate set by the Insurance Commissioner was confiscatory because it did not afford 20th Century an opportunity to recover its reasonable expenses and cost of capital. The Superior Court noted that the Ninth Circuit followed the same approach in striking down the Nevada counterpart to Proposition 103 in *Guaranty Nat'l Ins. Co.* v. *Gates*, 916 F.2d 508 (9th Cir. 1990). App. 187a.

On appeal, the California Supreme Court declined to follow *Gates* and the Ninth Circuit's understanding of *Hope*, instead concluding that this Court's decision in *Permian Basin Area Rate Cases*, 390 U.S. 747 (1968), had modified *Hope* so that rate regulation need not permit even an efficient company in a competitive market an opportunity to recover its cost of capital. Departing from the objective economic standard of *Hope*, the California Supreme Court held, without articulating any standards or criteria, that it could decide whether a rate was so low as to effect a taking through an entirely subjective balancing of investor and consumer interests.

This is a fundamental misunderstanding of both *Hope* and *Permian Basin*, but not an isolated one. Most courts adhere to the approach of the Superior Court below and the Ninth Circuit in *Gates*, construing *Hope* as safeguarding the right of regulated firms to charge rates that will afford them an opportunity to recover their reasonable expenses and cost of capital. *See* cases discussed *infra* at 19-24. Other courts, however, proceed along the lines of the California Supreme Court below, holding that the *Hope* standard is simply the prelude to a balancing of competing interests. *See* cases discussed *infra* at 25-28. The cases are in sharp conflict and cannot be reconciled. *Compare, e.g., Appeal of Public Serv. Co. of New Hampshire*, 130 N.H. 748, 547 A.2d 269, 270-271 (1988) ("a utility's threshold entitlement is to a rate of return equal to the cost of capital") *with* App. 116a (California Supreme Court criticizing Superior Court's "assumption * * * that a regulated firm is entitled to its cost of capital"). Only this Court can resolve this growing confusion over the meaning of its decisions, and it should grant certiorari to do so.

Although the opinions below are voluminous, and the formula employed by the Insurance Commissioner in ordering rollbacks dauntingly complex, the question we present to the Court in this petition is both straightforward and simply answered: Whether the California Supreme

Court articulated and applied the correct constitutional standard when it held that rate regulation need not permit a regulated company an opportunity to recover its cost of capital. If, as we submit—and as other state supreme courts and federal circuit courts have held—*Hope* requires that regulation allow such an opportunity, this case should be remanded so that 20th Century's claim and the claims of the other insurers can be evaluated under the proper constitutional criteria.

The question we present is also important and recurring, affecting not only the insurance industry in California but all industries subject to rate regulation across the Nation. The constitutional standard governing confiscation claims does not vary from industry to industry, and the uncertainty generated by the growing conflict among the lower courts on the appropriate standard spawns increased litigation over complex rate-setting issues. This Court should grant certiorari to resolve the conflict and reaffirm the constitutional protection for regulated property it articulated in *Hope*.

STATEMENT OF THE CASE

Proposition 103. On November 8, 1988, voters in California approved the ballot initiative known as Proposition 103, which fundamentally changed the regulation of insurance in California. Proposition 103 requires insurers to seek prior approval from the Insurance Commissioner for any change in insurance rates instituted after November 8, 1989. Cal. Ins. Code § 1861.01(c). For the period from November 8, 1988 to November 8, 1989 (the "rollback period"), Proposition 103 requires every insurer to reduce its rates to a level 20 percent less than the rate charged for the same coverage on November 8, 1987. *Id.* § 1861.01(a). Proposition 103 allowed an insurer to charge a rate for the rollback period higher than 80 percent of its 1987 rate only upon a finding by the Insurance Commissioner that the "insurer is substantially threatened with insolvency." *Id.* § 1861.01(b).

The Calfarm Decision. The California Supreme Court considered a facial challenge to Proposition 103 in *Calfarm Ins. Co.* v. *Deukmejian*, 48 Cal. 3d 805, 771 P.2d 1247, 258 Cal. Rptr. 161 (1989). The court held that Insurance Code § 1861.01(b) was facially invalid, explaining that allowing an insurer to charge a rate for the rollback period higher than 80 percent of its 1987 rate only if the insurer was "threatened with insolvency" violated the Fourteenth Amendment's requirement that a regulated entity must be allowed to receive a "fair return" on its investment. *Calfarm*, 771 P.2d at 1254 & n.10. The court held that this portion of Proposition 103 was severable and that its invalidation did not affect the remainder of the statute.

With respect to the rollback period, the *Calfarm* court held that any insurer who believed that the rate set by the statute was confiscatory could file an application with the Insurance Commissioner for approval of a higher rate. *Id.* at 1258. If the insurer filed an application before November 8, 1989, it could begin to charge the higher rate pending approval from the Commissioner. *Id.*

Regulations Implementing Proposition 103. Two years after the *Calfarm* decision, Insurance Commissioner John Garamendi promulgated regulations to determine the maximum permissible rates for the rollback period. The Commissioner determined that if the statutory rate of 20 percent lower than the 1987 rate is confiscatory for an insurer, then the proper rollback rate is the lowest possible non-confiscatory rate. Cal. Code Regs. tit. 10, § 2645.2(c). The Commissioner further determined that 10 percent was the minimal non-confiscatory rate of return, and that the 10 percent rate should be used in conjunction with a complex formula to calculate the rates an insurer could charge during the rollback period. *Id.* § 2645.6(a).

The Administrative Decision. The Commissioner chose 20th Century as a "test case," App. 34a, and on October

16, 1991, issued a show cause order directing the company to refund to its policyholders 13.3378 percent of the premiums it had collected during the rollback period, plus interest at the annual rate of 10 percent. *Id.* at 224a. A hearing on the order to show cause was conducted before an Administrative Law Judge ("ALJ"). After making some "technical corrections" in the application of the regulations, the ALJ determined that 20th Century was required to roll back its rates for the rollback period by 12.203 percent, *id.* at 369a, generating a refund obligation of 78 million dollars, plus interest. *Id.* at 149a.

The ALJ rejected 20th Century's argument that the Commissioner's maximum 10 percent rate of return was unconstitutionally confiscatory as applied to 20th Century. *Id.* at 271a-272a. The ALJ found that it was permissible for the Commissioner to use industry average rates of return for the prior ten years to reach the conclusion that 10 percent was the lower boundary of a reasonable rate of return, *id.* at 275a, and ruled that the unrebutted testimony of 20th Century's expert witnesses —which showed that 20th Century's actual cost of capital was at least 20 percent during the rollback period—was "immaterial." *See id.* at 30a. According to the ALJ, 20th Century could obtain relief from the rates imposed by the Commissioner only by showing that it would suffer "deep financial hardship;" no confiscation could be shown "so long as 20th Century continues to be able to operate successfully." *Id.* at 271a, 356a. The ALJ specifically ruled that the "minimum nonconfiscatory level need not be set at a rate of return that might theoretically have been needed to attract capital in [the rollback] year." *Id.* at 355a. The Insurance Commissioner adopted the ALJ's opinion and order as his own final decision.

Decision of the California Superior Court. 20th Century challenged the ALJ's decision by filing an action in the Superior Court for Los Angeles County.[1] The Su-

[1] 20th Century's suit was consolidated with a declaratory judgment action it had filed against the Commissioner, *20th Century*

perior Court reversed the ALJ and held that the Commissioner's regulations and order were unconstitutional both on their face and as applied.[2]

The Superior Court held that the Commissioner and ALJ applied the wrong legal standard in deciding that the rate of return permitted 20th Century was not confiscatory:

> This court has * * * ruled that erroneous standards inconsistent with *Calfarm* and *Hope* and constitutional requirements were applied by the administrative law judge. 20th Century did not have to show deep hardship or insolvency and had a right to [a] lower boundary reasonable rate of return that takes into consideration its cost of capital. Under *Calfarm*, to obtain relief from the rate set, the insurers do not have to show, as argued by the Commissioner at oral argument, that the rate "deprives me of the ability to cover my out-of-pocket costs." [App. 209a.]

The Superior Court explained that a constitutional rate of return "does not mean a break-even rate of return, but one that produces a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital." *Id.* at 177a. In support of this understanding the court cited *Hope* and the Ninth Circuit's decision in *Guaranty Nat'l Ins. Co.* v. *Gates*, 916 F.2d 508 (1990). The court explained that *Gates* had struck down the Nevada rollback statute because it "permitted only mar-

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Insurance Co. v. *Garamendi*, No. SFSC 938470, and with a portion of another action brought by petitioner State Farm, among others, against the Commissioner, *Hartford Steam Boiler Inspection and Insurance Co.* v. *Garamendi*, No. BC 023983.

[2] The Superior Court also held that the regulations and order were beyond the statutory authority provided by Proposition 103. App. 185a. That ruling was reversed by the California Supreme Court, *id.* at 59a-60a, and is not at issue here.

ginal or break-even rates"—precisely the ALJ's and Commissioner's understanding of a non-confiscatory rate in this case. App. 187a. As the Superior Court concluded, "[a] rate which only avoids deep hardship does not guarantee a fair rate of return." *Id.* at 177a n.20.

The Superior Court held further that the 10 percent rate of return provided by the regulations was confiscatory as applied to 20th Century. In the administrative hearing, according to the Superior Court, the Commissioner had not rebutted 20th Century's evidence that its reasonable rate of return during the rollback period was at least 20 percent. *Id.* at 202a.

California Supreme Court Decision. The California Supreme Court [3] reversed the Superior Court's judgment, holding that the Commissioner's regulations for determining rates for the rollback period were not unconstitutional, either in general or as applied to 20th Century.

On the confiscation issue the California Supreme Court rejected the Superior Court's understanding of the applicable legal standard and embraced that of the ALJ. According to the Supreme Court, the Superior Court was wrong to assume that "a regulated firm is entitled to its cost of capital." *Id.* at 116a. The *Hope* standard relied upon by the Superior Court in finding that the rates allowed 20th Century were confiscatory "describes an interest that the producer may pursue and not a right that it can demand. That interest is 'only one of the variables in the constitutional calculus of reasonableness,' " and must be balanced against the interests of consumers. App. 79a (quoting *Permian Basin Area Rate Cases*, 390 U.S. at

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[3] The Insurance Commissioner and intervenor Voter Revolt appealed the Superior Court's decision to the California Court of Appeal, and 20th Century and State Farm cross-appealed. The California Supreme Court, finding that the appeal "presents issues of imperative public importance requiring prompt resolution," granted the Commissioner's unopposed motion to transfer the appeal directly to the Supreme Court. App. 3a.

769). The Supreme Court explained that this balancing could result in a rate of return that failed to cover the cost of capital yet was nevertheless constitutional under the Takings and Due Process Clauses. App. 116a. The court stated that a regulated firm "has no constitutional right to a profit * * *, [i]ndeed, such a firm has no constitutional right even against a loss." *Id.* at 79a. The Supreme Court observed that the Ninth Circuit's opinion in *Gates* "may be read to erroneously state" that the constitutionally required fair return "must necessarily be above the 'break even' level," but the court below said it "will not indulge in such a reading." App. 79a n.18.

Instead, the court explained, a finding of confiscation required a showing of " 'deep financial hardship.' " App. 81a (quoting *Jersey Central Power & Light Co.* v. *FERC*, 810 F.2d 1168, 1181 n.3 (D.C. Cir. 1987) (en banc)).[4] Applying this standard to 20th Century, the court held that the insurer had failed to make the requisite showing, "because such a showing is precluded when, as here, the 'return which was allowed made it possible for the company to operate successfully.' " App. 125a (quoting *Market Street Ry.* v. *Railroad Comm'n*, 324 U.S. 548, 566 (1945)).[5]

A petition for rehearing was denied on September 29, 1994. App. 214a. On November 10, 1994, the Superior

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[4] The California Supreme Court quoted the "deep financial hardship" language from the footnote in *Jersey Central* no fewer than thirteen times in its opinion. App. 26a, 33a, 70a, 81a, 81a-82a, 83a (twice), 85a, 115a (twice), 121a, 122a (twice).

[5] Justice Mosk—the author of the court's opinion—also filed a separate concurrence, arguing that insurers had no possible takings claim, because they had the option of getting out of the business if they believed that the authorized rates were confiscatory. App. 131a-132a. He acknowledged that the decision in *Aetna Casualty & Sur. Co.* v. *Commissioner of Ins.*, 358 Mass. 272, 281, 263 N.E.2d 698 (1970) ("Insurers are not required to either submit to confiscatory rates or go out of business"), was "to the contrary." App. 132a n.1.

Court entered a stay pending this Court's disposition of the present petition for certiorari, finding that "the constitutional issues presented are of great public interest and there is reasonable likelihood that certiorari will be granted." *Id.* at 373a.

REASONS FOR GRANTING THE WRIT

I. THE DECISION BELOW CONFLICTS WITH THIS COURT'S PRECEDENTS

This Court recently reaffirmed that the Constitution protects an enterprise subject to rate regulation from rates that are so low that they effect a taking of the firm's property. As the Court stated in *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 308 (1989), "[i]f the rate does not afford sufficient compensation, the State has taken the use of utility property without paying just compensation and so violated the Fifth and Fourteenth Amendments." While the Court declined to examine the subsidiary elements of the ratemaking formula at issue in *Duquesne Light*, it was careful to note that the regulated firms in that case did not "allege[] that the total effect of the rate order arrived at within this system is unjust or unreasonable," or that the rates jeopardized their financial integrity "either by leaving them insufficient operating capital or by impeding their ability to raise future capital. Nor has it been demonstrated that these rates are inadequate to compensate current equity holders for the risk associated with their investments * * *." *Id.* at 311-312. Petitioners raised precisely those claims in this case, and the question we present to the Court in this petition is the straightforward one of whether the court below articulated and applied the correct legal standard in resolving those claims.

The Court has established certain basic principles governing its consideration of that question. Chief among these is the requirement that the rate afford the regulated firm an opportunity to earn a return sufficient to

cover its cost of capital.[6] As the Court explained in *Hope*:

> From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock. * * * By that standard the

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[6] The cost of providing a service or product includes both current and capital expenditures. To provide electricity, for example, an enterprise must incur current costs such as labor and supplies, as well as the capital cost of building the power plant. As Justice Brandeis pointed out, "there is no difference between the capital charge and operating expenses, depreciation, and taxes. Each is a part of the current cost of supplying the service; and each should be met from current income." *Southwestern Bell Tel. Co.* v. *Public Serv. Comm'n*, 262 U.S. 276, 306 (1923) (concurring in the judgment). A failure to afford the company the opportunity to be compensated for use of the capital confiscates the company's property to the same extent as a failure to afford it the opportunity to be compensated for current costs such as labor, for the commitment of capital to the enterprise carries a cost. That cost of capital, which is present regardless of whether a particular firm actually resorts to capital markets, is typically defined as an opportunity cost: "the expected rate of return in capital markets on alternative investments of comparable risk." A. Lawrence Kolbe and William B. Tye, *The* Duquesne *Opinion: How Much* "Hope" *Is There For Investors in Regulated Firms?*, 8 Yale J. on Reg. 113, 117-118 (1991). *See* App. 30a.

In the insurance industry, capital is committed to the enterprise not so much in the form of physical plant as in the maintenance of funds available to pay losses. That capital is at risk in the same economic sense as the capital committed to the power plant, and the well-being of an insurer depends upon recovery of the cost of that capital, as defined above, to the same extent. Referring to the capital in the insurance context as being "at risk" is in no sense a mere figure of speech. Petitioner 20th Century lost 92 percent of its capital as a result of losses arising from a single event, the January 1994 Northridge earthquake. A failure to allow a rate of return sufficient to permit an opportunity to cover the cost of capital is not only unconstitutional, for the reasons set forth in the text, but also represents a serious threat to the future ability of the industry adequately to insure risks.

> return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital. [320 U.S. at 603.]

Hope adopted the views expressed earlier by Justice Brandeis in his separate opinion, joined by Justice Holmes, in *Southwestern Bell Tel. Co.* v. *Public Serv. Comm'n*, 262 U.S. 276 (1923):

> The compensation which the Constitution *guarantees* an opportunity to earn is the reasonable cost of conducting the business. Cost includes not only operating expenses, but also capital charges. Capital charges cover the allowance, by way of interest, for the use of the capital, whatever the nature of the security issued therefor; the allowance for risk incurred; and enough more to attract capital. * * * [A] rate is constitutionally compensatory, if it allows to the utility the opportunity to earn the cost of the service as thus defined. [*Id.* at 291 (emphasis added).]

The Superior Court below correctly applied this precedent, holding that confiscation occurs when a rate fails to "produce[] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital." App. 177a. The California Supreme Court, however, adopted a new constitutional standard of confiscation, and reversed.

According to the California Supreme Court, the *Hope* standard "describes an interest that the producer may pursue and not a right that it can demand." App. 79a; *see id.* at 84a, 85a-86a, 116a, 123a. The court below explained that this interest must be balanced against consumer interests, and that a regulated firm can complain of confiscation only if the rates it is permitted to charge create "deep financial hardship." If the rates permit the company "to operate successfully"—defined by the court

below to mean no more than covering out-of-pocket expenses—then there has been no constitutional violation. *See id.* at 79a-80a & n.18. The California Supreme Court expressly concluded that the Superior Court erred in linking the definition of a nonconfiscatory rate of return to one sufficient to cover the capital costs of the enterprise. *Id.* at 83a-84a ("confiscation does *not* arise, as the superior court erroneously believed, whenever a rate does not 'produce[] a profit which an investor could reasonably expect to earn in other businesses with comparable investment risks and which is sufficient to attract capital' ") (emphasis in original).

The court below based its new standard for review of confiscation claims on two isolated sentence fragments taken out of context from two opinions of this Court, fragments the court below repeatedly invoked like a mantra. The court minimized the constitutional significance of this Court's guidance in *Hope* by repeated quotation of a truism in *Permian Basin* to the effect that the investor's interest was "only one of the variables in the constitutional calculus of reasonableness," 390 U.S. at 769, and of *Market Street Ry.* v. *Railroad Comm'n*, 324 U.S. at 566, to the effect that "a company [cannot] complain if the return which was allowed made it possible for the company to operate successfully." *See* App. 80a, 81a, 82a, 114a, 125a. These sentence fragments do not support the California Supreme Court's new test, or justify its abandonment of the careful guidance provided by this Court in *Hope*.

The Court in *Permian Basin* did not purport to rule that *Hope*'s teaching that confiscation occurred if a regulated entity was denied an opportunity to recover its cost of capital was no longer good law. Quite the contrary: the Court in *Permian Basin* specifically reaffirmed that a court reviewing rate orders "must determine whether the order may reasonably be expected to *maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed*, and yet pro-

vide appropriate protection to the relevant public interests, both existing and foreseeable." 390 U.S. at 792 (emphasis added). Indeed, this Court upheld the rate order in *Permian Basin* only after finding that "the record before the Commission contained evidence sufficient to establish that these rates, as adjusted, will maintain the industry's credit and *continue to attract capital.*" *Id.* at 812 (emphasis added).

What the Court considered in *Permian Basin* was a challenge to the setting of maximum rates on an area-wide basis, and the Court simply held that "[n]o constitutional objection arises from the imposition of maximum prices merely because" higher-cost operators may be more adversely affected than others, or because regulation reduces the value of regulated property. It was in the course of rejecting these broad challenges that the Court noted that investor interests are "only one of the variables in the constitutional calculus of reasonableness." *Id.* at 769. *Permian Basin* simply cannot properly be cited to support a new test for confiscation that accepts rates below the level necessary to cover the cost of capital reasonably invested in providing the regulated service.[7]

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[7] Two Justices have already cautioned against relying on the sentence from *Permian Basin* that figured so prominently in the opinion below. In *FCC* v. *Florida Power Corp.*, 480 U.S. 245 (1987), this Court upheld rates based on "fully allocated cost, including the actual cost of capital." *Id.* at 254. Justice Marshall's opinion for the Court quoted the same sentence from *Permian Basin* repeatedly quoted by the court below. *Id.* at 253. This triggered a separate concurrence by Justice Powell, joined by Justice O'Connor, noting that "[t]he inquiry mandated by the Constitution is considerably more complex than this simple statement reflects," that "[t]he one sentence [from *Permian Basin*] * * * in no way accurately portrays the full rationale of judicial review of ratemaking by administrative tribunals," and that "no purpose is served by selecting for quotation a single sentence that, standing alone, is meaningless at best." *Id.* at 255-256. Whatever the wisdom of quoting the single sentence from *Permian Basin* in *Florida Power* in the course of upholding a rate that on its face included recovery of "the actual cost of capital," relying on that sentence as justification for a hold-

The sentence from *Market Street* is also taken out of context and similarly offers no support for the California Supreme Court's new test. *Market Street* concerned the exceptional situation of "a particularly ailing unit of a generally sick industry"—the urban streetcar industry in the 1940s. 324 U.S. at 554. The case did not involve an application of the *Hope* principles; on the contrary, this Court specifically noted that those principles "obviously are inapplicable to a company whose financial integrity already is hopelessly undermined, which could not attract capital on any possible rate, and where investors recognize as lost a part of what they have put in." *Id.* at 566. The Court simply held that regulation need not provide a return that *exceeds* that which the company could conceivably earn in the marketplace. *See id.* at 566-567. That is not what is at issue here.

In the course of explaining that *Hope* did not guarantee protection against market forces, the Court in *Market Street* stated that *Hope* held that "a company could not complain if the return which was allowed made it possible for the company to operate successfully." 324 U.S. at 566. While the California Supreme Court below read "operate successfully" as if it meant bare survival, or covering out-of-pocket expenses, *Hope* itself makes clear that to "operate successfully" includes covering capital costs:

> Rates which enable the company to operate successfully, to maintain its financial integrity, to attract capital, and to compensate its investors for the risks assumed certainly cannot be condemned as invalid, even though they might produce only a meager return on the so-called "fair value" rate base. [320 U.S. at 605.]

Nothing in *Market Street* remotely implies any departure from this standard of what rates must cover, apart from

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ing that such recovery is not constitutionally required is plainly distorting the teachings of this Court.

the exceptional situation of an ailing company in an industry dying due to market forces.[8]

Petitioners do not contend that every regulated firm must receive sufficient revenue from the rates it is permitted to charge to cover its cost of capital. Regulation does not assure insulation from market forces, and poorly run firms can lose money in a regulated as well as an unregulated industry. 20th Century, however, has consistently charged among the lowest rates for automobile and homeowners insurance of any company in California. By the Insurance Commissioner's own measure, 20th Century easily meets the "efficiency standard" for its category of insurance company, which is itself the most efficient category. *See* Cal. S. Ct. App. 12550-51. This is therefore plainly not a case like *Permian Basin*, in which high-cost operators objected to industry-wide rates, or like *Market Street*, in which a dying firm sought protection from the market.

Yet the California Supreme Court relied on these cases—holding simply that the Constitution affords no

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[8] This Court in *Market Street* stressed the peculiar nature of the facts before it, and expressly warned that the facts did not fit the pattern of "utilities whose economic situation would yield a permanent profit, denied or limited only by public regulation." 324 U.S. at 566. Despite this caution, the court below devised its new confiscation standard—applicable to assess the rate of return for one of the least expensive and most efficient companies in the business—largely on the basis of language taken out of context from *Market Street*.

The court below also cited *Market Street* for the startling holding that "a rate is not necessarily 'confiscatory' even if it 'compel[s]' a regulated firm 'to operate at a loss.'" App. 79a (quoting *Market Street*, 324 U.S. at 564). This statement in the opinion below is jerry-built from a description of the aggrieved party's *argument* in *Market Street*. *See* 324 U.S. at 564 ("The order is asserted to be invalid because it is said to be confiscatory and to compel appellant to operate at a loss"). What this Court held was *not* that the company could be compelled to operate at a loss, but that—because the property at issue had no value save salvage value—the owners "suffer *no loss* if they earn a return on salvage value," which they did. *Id.* at 567 (emphasis added).

protection against losses imposed by bad management or adverse market conditions—for the quite different proposition that it affords no protection for losses imposed by the government. The interests of consumers may indeed be balanced against those of investors in setting rates, and investors have no constitutional claim so long as they are afforded an opportunity to recover their reasonable expenses and cost of capital. When the weighing of consumer interests depresses rates below the point of a rate of return permitting recovery of the reasonable cost of capital, however, the regulation has effected a taking.

Once that established constitutional floor is abandoned, moreover, the constitutional right to be free of confiscatory rates is at the mercy of a standardless and ill-defined balancing test. The California Supreme Court provided no guidance on how a court should review the weighing of the respective interests of industry and consumers, or even how those interests should be identified. This Court has, of course, noted that evaluation of rate-making orders under constitutional standards is always a difficult task. *See Duquesne Light*, 488 U.S. at 308. That difficulty, however, has never led this Court simply to abandon the effort. Rather, the Court has identified certain constitutionally-required elements of the inquiry, and has evaluated rate-making orders against these elements. Thus, while difficult, the inquiry is not standardless. The California Supreme Court, by contrast, rejected the use of objective standards in favor of a limitless and effectively meaningless balancing test.

It is no answer to contend that the California Supreme Court's legal standard is immaterial because the Commissioner's rollback formula purportedly grants insurers a 10 percent rate of return. First, although the Commissioner determined that a 10 percent return was the minimum permitted by the Constitution, App. 185a, his formula guarantees that no insurer will in fact obtain even that return. As the Superior Court recognized, the formula "automatically," "inherently," and "unavoidably

does not permit even the lower boundary generic reasonable rate of return of 10 percent determined by the Commissioner." *Id.* at 184a. *See id.* at 177a n.20, 184a n.30. Thus, while the California Supreme Court stated that 20th Century's permitted rate of return was 11 percent, *id.* at 126a, the Commissioner himself calculates it at approximately 8 percent. Opening Brief of the Department of Insurance to the California Supreme Court, at 82-83.

Second, the Commissioner's choice of 10 percent as the minimum constitutional rate was based on average rates of return for the industry from 1980 to 1989, App. 27a, but the unrebutted record evidence shows that for 1989—the period of the rollback—the average cost of capital for the insurance industry was approximately 16 percent. *Id.* at 93a. In addition, the Superior Court found that the evidence establishing 20th Century's cost of capital at 20 percent was unrebutted, *id.* at 210a, and the California Supreme Court expressly acknowledged that 20th Century's cost of capital "was found to be at least 20 percent." *Id.* at 116a.[9]

The issue before this Court is not what return 20th Century actually received under the formula, or what 20th Century's cost of capital was during the rollback period. The question instead is whether 20th Century's claim was evaluated under the correct legal standard. The Superior Court applied the correct standard and found that the rates 20th Century was permitted to charge were confiscatory because they did not allow it to recover its reasonable cost of capital. The Supreme Court reversed not on the basis of a contrary factual determination, but because it applied a different legal standard—one which did not look to cost of capital in determining whether the permitted rates were confiscatory. If, as we submit, this was error under *Hope*, this Court should remand so that

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[9] All insurers do not have the same cost of capital; rather, their reasonable cost of capital varies based on factors such as the level of risk insured, the extent to which the company is leveraged, and the size of the company.

the California Supreme Court may consider the record evidence under the correct constitutional standard. The decision of the Superior Court plainly indicates that which legal standard is applied makes a difference on the concrete facts of this case.

II. THE COURTS ARE IN CONFLICT OVER THE LEGAL STANDARD APPLICABLE TO CLAIMS THAT REGULATED RATES ARE CONFISCATORY

The decision below conflicts directly with scores of decisions from other state courts of last resort, and from various federal circuit courts of appeals, which recognize that a regulated entity is subject to confiscation in violation of the Fifth and Fourteenth Amendments if it is denied an opportunity to recover its cost of capital. Perhaps the clearest conflict is with the decision of the Ninth Circuit in *Guaranty Nat'l Ins. Co.* v. *Gates*, 916 F.2d 508 (9th Cir. 1990), which struck down as unconstitutional the Nevada counterpart to Proposition 103, Chapter 784. The Ninth Circuit noted that Chapter 784 defined insurance rates as adequate if they did no more than cover projected losses and expenses. This definition "guarantees only that an insurer will break even; it does not guarantee the constitutionally required 'fair and reasonable return.'" 916 F.2d at 515. The court of appeals then immediately quoted from this Court's decision in *Hope* to make clear that a " 'fair and reasonable return' " must include " 'enough revenue not only for operating expenses but also for the capital costs of the business. These include the service of the debt and dividends on the stock.' " 916 F.2d at 515 (quoting *Hope*, 320 U.S. at 603). Because Chapter 784's definition of an adequate rate did not allow for recovery of capital costs, it was "constitutionally unacceptable." 916 F.2d at 515.

As the *Gates* court pointed out, Proposition 103—unlike Chapter 784—does not itself define an "inadequate" rate. 916 F.2d at 515. The decision of the California Supreme Court below, however, clearly held that a rate

could be considered adequate under the Proposition 103 rollback even if it failed to afford an insurer an opportunity to recover its cost of capital—the precise flaw that led the Ninth Circuit to strike down Chapter 784. The court below all but acknowledged the conflict, and did not even attempt to distinguish *Gates*:

> In *Guaranty Nat. Ins. Co.* v. *Gates* * * * there is language that may be read to erroneously state that the producer is constitutionally "guarantee[d]" a " 'fair and reasonable return[,]' " and that such a return must necessarily be above the "break even" level. We will not indulge in such a reading. [App. 79a n.18.]

Whether the court below chooses to "indulge in" it or not, the reading is unavoidable: the *Gates* court found the rate allowed by Chapter 784 inadequate because it guaranteed only the break even level, with no return for cost of capital. The court below reached the contrary result, upholding a rate without insisting that it allow an insurer the opportunity to recover its cost of capital.

The decision below also conflicts with the New Jersey Supreme Court's opinion in *State Farm Mut. Auto. Ins. Co.* v. *New Jersey*, 124 N.J. 32, 590 A.2d 191 (1991). That case considered a state law imposing certain charges on automobile insurers and prohibiting them from passing those charges directly through to insureds. The court upheld the law only after finding that the state regulatory authorities could take the charges into account in setting the fair rate of return the insurers could earn. *Id.* at 206. In considering the constitutionally required level of return, the New Jersey court explained that in *Hope* "the Court made clear that participants in a regulated industry are entitled to something more than mere survival." *Id.* at 199. This understanding of *Hope* is in contrast to that of the California Supreme Court below, which regarded as "erroneous[]" the proposition that a fair and reasonable return "must necessarily be above the 'break even' level." App. 79a n.18. The next passage in the New

Jersey Supreme Court's opinion sharpened the conflict: "[T]he constitutional *requirement* that a business be permitted a return sufficient to assure its financial health does not necessarily require any particular level of profit *above* what is adequate to attract and retain capital." 590 A.2d at 199 (emphases added). A return sufficient to assure financial health does, however, require a return *at least* at a level sufficient to cover capital costs—*i.e.*, "adequate to attract and retain capital." It is only *above* that level that the investor concerns identified in *Hope* are subject to balancing in light of competing consumer interests.

The court below did try to distinguish another conflicting case, this one from the D.C. Circuit. The California court, after reiterating that a regulated firm had "no right" to its cost of capital, App. 116a, stated that

> *Tennessee Gas Pipeline Co.* v. *FERC* (D.C. Cir. 1991), 926 F.2d 1206, on which 20th Century and the other insurers rely, is not to the contrary. That the [FERC] might "endeavor[] to set a utility's rate of return on equity at its cost of equity capital" as a matter of policy (*id.* at p. 1208) does not mean that another regulator must do the same under constitutional compulsion. [App. 116a n.27.]

But the D.C. Circuit in *Tennessee Gas* rather plainly did not view recovery of cost of capital as simply "a matter of policy." Instead, the court noted that FERC set the rate of return at the cost of capital because FERC "[r]ecogniz[ed] that utility investors *must* be allowed an opportunity to earn returns sufficient to 'attract capital' * * * and 'to compensate [the] investors for the risks assumed.' " 926 F.2d at 1208 (emphasis added) (quoting *Hope*, 320 U.S. at 605). Like the Ninth Circuit in *Gates* and New Jersey Supreme Court in *State Farm*, the D.C. Circuit in *Tennessee Gas* recognized that this Court's decision in *Hope* held—contrary to the holding below—that a constitutionally adequate rate of return must at a minimum afford the regulated entity the opportunity to recover its cost of capital.

Because it is home to various federal agencies that engage in regulating rates, the D.C. Circuit has considerable experience in applying this Court's precedents on the constitutional limits of such regulation. Many other cases from the D.C. Circuit confirm the proper reading of *Tennessee Gas*. In *United States* v. *FCC*, 707 F.2d 610 (D.C. Cir. 1983), for example, the court explained:

> Regulated utilities are *entitled* to earn enough revenue not only to cover operating expenses but also to pay for the capital costs of doing business, including service on debt and dividends on stock. The return to the equity owner *must* be "sufficient to assure confidence in the financial integrity of the enterprise," *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), in order that its credit may be maintained and capital may continue to be attracted. [*Id.* at 612 (emphases added).]

See also AT&T v. *FCC*, 836 F.2d 1386, 1389-90 (D.C. Cir. 1988) ("The rate of return * * * *must* be sufficient to cover the cost of capital the carrier must raise to do business") (emphasis added).

This understanding contrasts sharply with the approach of the California Supreme Court below, which criticized the Superior Court for its view that "the lower boundary of the range of reasonable rates of return for a regulated firm is its cost of capital" and rejected the "assumption * * * that a regulated firm is entitled to its cost of capital." App. 115a-116a. There is simply no way to reconcile the D.C. Circuit's view that regulated firms "are entitled" to a rate of return adequate to cover the cost of capital, and the California Supreme Court's view that an entity "has no right" to such a rate of return. *Id.* at 116a.

The New Hampshire Supreme Court in *Appeal of Public Serv. Co. of New Hampshire*, 130 N.H. 748, 547 A.2d 269 (1988), expressly read *Hope* the same way as the Ninth and D.C. Circuits and the New Jersey Supreme

Court. Reviewing "familiar standards of public utility ratemaking," Justice Souter cited *Hope* for "the rule that a utility's *threshold entitlement* is to a rate of return equal to the cost of capital." 547 A.2d at 270-271 (emphasis added). *See also Appeal of Cheshire Bridge Corp.*, 126 N.H. 425, 493 A.2d 1151, 1156 (1985) ("*At a minimum*, the return must equal the cost of capital * * *. A utility's cost of capital is the cost of borrowing money and the cost of attracting equity investment.") (Souter, J.). This understanding of the minimum necessary to avoid confiscatory rates is reflected in numerous opinions from other state supreme courts as well.[10]

Despite its prominence in the California Supreme Court's opinion, nothing in *Jersey Central Power & Light*

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[10] *See, e.g., Alabama Power Co.* v. *Alabama Pub. Serv. Comm'n*, 422 So. 2d 767, 770 (Ala. 1982) ("constitutionally mandated fair rate of return * * * involves cost of debt capital, cost of preferred stock, and cost of equity capital"); *Central Maine Power Co.* v. *Public Utils. Comm'n*, 153 Me. 228, 136 A.2d 726, 740 (1957) ("It is repeatedly stated or implied in the decided cases, so far as we know without contradiction, that one of the constitutional rights of a regulated utility is the right to earn a sufficient return to maintain its credit and to obtain additional capital when needed to enable it to serve its public") (quoting *New England Tel. & Tel. Co.* v. *Department of Pub. Utils.*, 327 Mass. 81, 97 N.E.2d 509, 516 (1951)); *Attorney General* v. *Department of Pub. Utils.*, 392 Mass. 262, 467 N.E.2d 72, 75 (1984) ("In general, the return on equity must equal at least the amount which the company would have to pay in order to 'hire' its equity capital under current conditions") (citation omitted); *Mountain States Tel. & Tel. Co.* v. *Department of Pub. Serv. Regulation*, 191 Mont. 331, 624 P.2d 481, 482 (1981) ("It is a basic principle of utility regulation that a utility is entitled to receive a fair and reasonable rate of return on its investment in plant and equipment used to provide its services to the public. In determining a fair and reasonable rate of return, it is necessary to determine what it costs the utility to secure the required capital to finance its operations"); *Hastings* v. *Village of Stowe*, 125 Vt. 227, 214 A.2d 56, 61 (1965) ("the rate of return must be sufficient to provide enough revenue for capital costs of the business, including service on the debt and dividends on the stock").

Co. v. *FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (en banc), is to the contrary. The court below repeatedly quoted a fragment of a sentence from a footnote in *Jersey Central* for the proposition that there could be no confiscation absent " 'deep financial hardship.' " *See* App. 81a, 83a, 121a (quoting 810 F.2d at 1181 n.3). What the D.C. Circuit actually said, however, was that "absent the sort of deep financial hardship *described in* Hope, there is no taking, and hence no obligation to compensate, just because a prudent investment has failed and produced no return." 810 F.2d at 1181 n.3 (emphasis added).

The text of the majority opinion in *Jersey Central*—ignored by the court below—explains what the D.C. Circuit meant by "the sort of deep financial hardship described in *Hope*." First, the court rejected the regulatory agency's argument that confiscation occurred only if the rate would drive the regulated firm into bankruptcy as "dramatically at odds with the law." 810 F.2d at 1175. As the D.C. Circuit explained, under *Hope* "[t]he return * * * 'should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital.' " *Id.* at 1176 (quoting *Hope*, 320 U.S. at 603). The D.C. Circuit made clear that a company "less imminently imperiled" than one about to go into bankruptcy could state a claim under *Hope*, 810 F.2d at 1180, and indicated that Jersey Central exhibited "the sort of deep financial hardship described in *Hope*" precisely because low rates had resulted in it being "shut off from long term capital" and unable to pay dividends for four years. *Id.* at 1181. In other words, a company that is not afforded an opportunity to recover its capital costs is "in the sort of financial difficulty described in Justice Douglas' opinion [in *Hope*]." *Id.* at 1181 n.3. Justice Douglas' opinion in fact described no other sort of financial difficulty, so the "deep financial hardship described in *Hope*" can only be the inability to recover capital costs. The California Supreme Court's effort to pluck an incomplete portion of the just-quoted

phrase from a footnote in *Jersey Central* and erect around it a test different from the cost of capital standard articulated in the text of *Jersey Central* and *Hope* itself is thus wholly unfounded.

The clearest confirmation that the court below misread *Jersey Central* comes from reading the *Jersey Central dissent*, which proceeds along the same lines as the California Supreme Court. The dissent criticizes the *Jersey Central* majority for concluding that "a rate is confiscatory if it does not *satisfy* the 'legitimate investor interest' outlined by the Court in *Hope*." *Id.* at 1210 (Mikva, J., dissenting) (emphasis in original). According to the *Jersey Central* dissent—and the court below—*Hope* simply "specified the interests at issue but did not require that rates fulfill them in order to be non-confiscatory." *Id.* at 1210-11. Like the court below, the dissent quoted this Court's opinion in *Market Street* for the proposition that *Hope* held only that a company could not complain if the allowed return permitted it to operate successfully, and —again like the court below—cited *Permian Basin* for the proposition that investor interests were "only one factor in the assessment of constitutionally reasonable, therefore non-confiscatory, rates." *Id.* at 1211. The dissent—like the court below—reached the ultimate conclusion that a just and reasonable rate "might not provide 'enough revenue not only for operating expenses but also for the capital costs of the business.' " *Id.* (quoting *Hope*, 320 U.S. at 603). The dissent was quite right to read the *Jersey Central* majority as interpreting *Hope* to mean that an opportunity to recover the cost of capital must be permitted. For all its relentless quotation of a fragment from the majority opinion, the California Supreme Court below rather plainly lined up with the *Jersey Central* dissent's reading of *Hope*, not the majority's.

As the dissent in *Jersey Central* indicates, however, the California Supreme Court is not alone in its misreading of this Court's decisions in *Hope*, *Permian Basin*, and *Market Street*. Other courts—albeit a distinct minority—

have agreed with the view that *Hope* simply establishes a starting point for evaluating investors' interests, and that balancing those interests against the competing interests of consumers may yield a constitutional rate that does not return to the firm its expenses and cost of capital.

In *Pennsylvania Elec. Co.* v. *Pennsylvania Pub. Util. Comm'n*, 509 Pa. 324, 502 A.2d 130, *appeal dismissed for want of substantial federal question*, 476 U.S. 1137 (1986), the Pennsylvania Supreme Court rejected the contention that *Hope* set a constitutional standard requiring that a regulated entity's permitted rate of return cover the cost of capital:

> The decision in *Hope* enumerated certain legitimate areas of concern for investors, these being that a company have sufficient revenue to cover operating and capital costs, that the return on equity be commensurate with returns on enterprises having similar risks, and that the company be able to maintain credit and attract capital. These investor interests are appropriate factors to be weighed in the balancing analysis under *Hope*, but they are not, in themselves, controlling, for other factors must be taken into account. [502 A.2d at 134.]

A majority of the Ohio Supreme Court relied on *Pennsylvania Elec. Co.* in *Ohio Edison Co.* v. *Public Utils. Comm'n*, 63 Ohio St. 3d 555, 589 N.E.2d 1292 (1992), declining to "raise the investor concerns listed in *Hope* to a constitutional level. The federal constitutional cases * * * recognize investor concerns as only one factor that the commission is to consider in setting just and reasonable (*i.e.*, constitutional) rates." 589 N.E.2d at 1299-1300. The court explained that "[o]nce these interests are appropriately balanced, the rates' effect on the company's financial integrity (*i.e.*, debt rating and dividend level) is but another of the risks which a utility, as any other unregulated enterprise, must bear." *Id.* at 1300. The court concluded by offering its view that "the Constitution no longer provides any special protection

for the utility investor." *Id.* at 1300 n.8 (citation omitted). Justice Wright, joined by Justice Holmes, dissented. He stressed that Ohio Edison had offered "evidence that the proposed rate would impede its ability to obtain credit and attract capital." *Id.* at 1302. Citing the D.C. Circuit's opinion in *Jersey Central*, Justice Wright argued that the Commission's order should be reversed and the case remanded for consideration of the company's evidence. *Id.*

A majority of the Kansas Supreme Court adopted the reasoning of *Pennsylvania Elec. Co.* in *Kansas Gas & Elec. Co.* v. *State Corp. Comm'n*, 239 Kan. 483, 720 P.2d 1063, 1071 (1986), *prob. juris. noted*, 479 U.S. 1082, *app. dismissed*, 481 U.S. 1044 (1987), stating that

> the decisions of the United States Supreme Court in *Hope* and *Permian Basin Area Rate Cases* did not establish, as a constitutional requirement, that the end result of a ratemaking body's adjudication must be the setting of rates at a level that will, in any given case, guarantee the continued financial integrity of the utility. Rather, *Hope* requires only that the regulatory authority balance competing consumer and investor interests to determine just and reasonable rates providing a return on used and useful property.

Like the Ohio Supreme Court in *Ohio Edison* and the D.C. Circuit in *Jersey Central*, the Kansas Supreme Court was divided.[11] Justice Schroeder dissented and concluded that the orders at issue resulted in a confiscatory taking of the company's property. *Id.* at 1089.

The approach of these courts—and of the court below—abandons the *Hope* criteria in favor of essentially standardless balancing. A requirement that regulatory authorities "consider" investor interests in recovering rea-

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[11] These frequent divided opinions on the question presented are further evidence of the growing uncertainty over the governing legal standard, confirming the need for this Court to grant certiorari and provide guidance to the lower courts.

sonable expenses and the cost of capital is scant protection for property if those interests, once considered, can be overridden by competing consumer interests. We recognize that such balancing is permitted so long as profit levels are "above what is adequate to attract and retain invested capital," *State Farm*, 590 A.2d at 199, because there can be no constitutional objection simply because "the value of regulated property is reduced as a consequence of regulation." *Permian Basin*, 390 U.S. at 769. To take the minimum level necessary to attract and retain capital as the starting point, however, and to authorize lower rates in light of consumer interests, is simply taking the investors' property for the public's benefit without just compensation, in violation of the Takings Clause.

III. THE QUESTION PRESENTED IS IMPORTANT AND RECURRING

The question presented is obviously an important one. *See* App. 3a (case "presents issues of imperative public importance"); *id.* at 373a ("the constitutional issues presented are of great public interest"). 20th Century's rollback liability alone is more than 78 million dollars, and the rollback liability of the California insurance industry as a whole under the approach sanctioned by the court below totals more than 2.5 *billion* dollars. 20th Century's case was taken as a test case; hundreds of similar applications wait in the wings. *See id.* at 34a & n.6.

The significance of the case is not limited to California. As the Superior Court cautioned, the significance of Proposition 103 should not be underestimated, because it "has served as a model for insurance legislation in other states." *Id.* at 148a. *See, e.g.*, 75 Pa. Cons. Stat. § 1799.7(b); S.C. Code Ann. § 38-73-465(D). Quite apart from that significance, the decision below has a direct impact on insurance regulation in states beyond California. To the extent that California does not allow insurers to recover the cost of capital through the rates

they charge insureds in California, insurers who also provide insurance outside of California will find their overall capital diluted and their ability to meet their coverage obligations correspondingly diminished. This directly affects the interests of insureds in other states and undermines the regulatory regimes in those other states, particularly when the action is taken on a retrospective basis, so officials in other states cannot respond to the increased threat to insureds in their state. Only a ruling by this Court can redress these adverse extraterritorial impacts of the decision below.

In addition, the question of the appropriate constitutional standard to apply to claims that rates are confiscatory under the Fifth and Fourteenth Amendments is in no sense limited to the insurance context. The question arises regularly in a wide array of regulated industries, from utilities to cable television to rental housing. The constitutional standard does not vary from industry to industry, and the conflict in the lower courts exacerbated by the decision below is felt across the spectrum of regulated industries.

CONCLUSION

For the foregoing reasons, this Court should grant the writ and reverse the decision below.

Respectfully submitted,

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